

Attachment A



Federal Housing Finance Board

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September 8, 1998

Mr. James F. Hinchman
Acting Comptroller General
U. S. General Accounting Office
Washington, DC 20548

Re: Draft report of the United States General Accounting Office entitled "Federal Housing Finance Board -- Actions Needed to Improve Regulatory Oversight," prepared pursuant to the request of Richard Baker, Chairman, Subcommittee on Capital Markets, Securities and Government-Sponsored Enterprises, Committee on Banking and Financial Services, House of Representatives.

Dear Mr. Hinchman:

I appreciate the opportunity to provide comments on the above-referenced draft General Accounting Office (GAO) report.

The methodology chosen by the General Accounting Office focused primarily on the examination activities of the Finance Board, just one aspect of our regulatory activities. As a result, the draft report inappropriately extrapolates from the very limited scope of the audit performed to draw overly broad, inaccurate and unsubstantiated conclusions about the adequacy of the agency as both a safety and soundness and a mission regulator. I thus request that these written comments, including the enclosure, be included in their entirety in the final report to better ensure its accuracy and completeness.

As the independent regulator of the Federal Home Loan Bank System, the Federal Housing Finance Board (Finance Board) is charged by statute with the primary duty of ensuring that the 12 Federal Home Loan Banks (FHLBanks) operate in a financially safe and sound manner. The Federal Home Loan Bank Act also requires that the Finance Board, consistent with its primary duty, supervise the FHLBanks and ensure that the FHLBanks carry out their housing finance mission and remain adequately capitalized and able to raise funds in the capital markets.

As required by law, safety and soundness is the primary consideration in everything the Finance Board does, from promulgating regulations, to developing policies and procedures, to authorizing pilot programs. The safety and soundness requirements prescribed for the FHLBanks in statute, regulation and policy are more stringent and conservative than those for

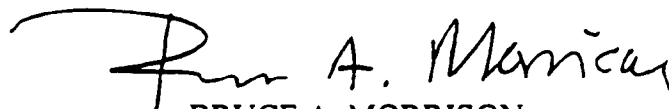
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federally insured depository institutions or for other government-sponsored enterprises. This results in a System with a AAA-rating (without reference to its implied government backing), which has not experienced a credit loss since its inception in 1932. Because I do not see evidence that GAO considered this statutory and regulatory context in reaching conclusions as to the Finance Board's safety and soundness regulatory regime, the enclosure describes these requirements in detail.

The draft report mistakes the Finance Board's authorization of certain activities, and its identification for the FHLBanks of appropriate ways to fulfill their housing finance mission, for intrusion into the business of the FHLBanks. In fact, the Finance Board's strategy of actively encouraging the development by the FHLBanks of mission-related assets and reduction in holdings of non-mission related assets, also detailed in the enclosure, is entirely consistent with the Finance Board's statutory mandate to ensure that the FHLBanks carry out their housing finance mission.

Despite the methodological flaws and unsupported conclusions in the draft report, I believe it contains a number of useful suggestions that we will evaluate and implement, where appropriate, to improve the quality of the Finance Board's examination process.

Sincerely,

A handwritten signature in black ink, appearing to read "Bruce A. Morrison". The signature is fluid and cursive, with a large initial "B" and "M".

BRUCE A. MORRISON
Chairman

Enclosure

cc: Hon. Richard H. Baker
Hon. Paul E. Kanjorski

FEDERAL HOUSING FINANCE BOARD

Comments on GAO Draft Report

“Federal Housing Finance Board: Actions Needed to Improve Regulatory Oversight”

The Federal Housing Finance Board (Finance Board) has the primary statutory duty of ensuring that the 12 Federal Home Loan Banks (FHLBanks) operate in a financially safe and sound manner. The Federal Home Loan Bank Act (Bank Act) also requires that the Finance Board supervise the FHLBanks and ensure that the FHLBanks carry out their housing finance mission and remain adequately capitalized and able to raise funds in the capital markets.¹ The statutory charge to “ensure” requires the Finance Board to be results-oriented rather than process-oriented with respect to its two fundamental duties: (1) ensuring safety and soundness; and (2) ensuring that the FHLBanks carry out their housing finance mission. These duties are the primary responsibility of the entire 115-person agency.

I. Ensuring the safety and soundness of the FHLBank System.

- A. *The safety and soundness policies prescribed for the FHLBanks by the Finance Board are more stringent and conservative than those that apply to federally insured depository institutions or to other government sponsored enterprises. The FHLBanks are AAA-rated (without regard to their implied government backing) and have not experienced a credit loss since their creation in 1932. Annual on-site examinations, together with comprehensive reporting and off-site monitoring, ensure regulatory compliance with these policies.*

The Finance Board fulfills its primary statutory duty to ensure the safety and soundness of the FHLBanks in a number of ways. Annual on-site examinations are only one of the Finance Board’s safety and soundness tools. Safety and soundness also is critically dependent on the adequacy of: (1) the Bank Act, and the Finance Board's regulations and policies that limit the amount of risk that the FHLBanks can assume; (2) the corporate governance, risk management, auditing and disclosure policies and

¹ See 12 U.S.C.A. §§ 1422a(3)(A), (B).

procedures that the FHLBanks are required to have in place to identify and manage their risks; and (3) the amount of capital that is available to absorb any losses that may occur at the FHLBanks.

1. Finance Board Regulations and Policies Tightly Control Risk.

The operations of the FHLBanks involve two major risks – credit risk and interest rate risk. Both types of risk are tightly controlled, either by the Bank Act, Finance Board regulations and policies, or both. These risks are also qualitatively different from, and inherently lower than, the risks facing federally insured depository institutions because of the FHLBanks' unique role of lending on a fully secured basis to their member institutions, who are themselves regulated for safety and soundness by federal and state regulators. Unlike many insured commercial banks, the FHLBanks also do not engage in trading operations.

Credit Risk Controls. The lending and investment activities of the FHLBanks that expose them to credit risk are prescribed by statute and further constrained by the regulations and policies of the Finance Board. Because the primary business of the FHLBanks is making loans (called advances) to their members and certain nonmember borrowers, advances represent the major asset held by the Banks. The Bank Act prescribes that advances must be fully secured by a very limited statutory list of eligible collateral, principally mortgage and other real estate related collateral, obtained from their members.² The FHLBanks also have a statutory lien on the stock of their borrowing members, and certain members must hold additional stock against advances.³ The FHLBanks may also require additional collateral security for an advance whenever deemed necessary for their protection and have access to their members' safety and soundness examination reports.⁴

In addition to these statutory protections, the Finance Board imposes regulations and policies,⁵ which further define eligible collateral, require the

² *Id.*, § 1430(a).

³ *Id.*, § 1430(c), (e).

⁴ *Id.*, §§ 1430(d), 1422.

⁵ 12 C.F.R. Part 935.

FHLBanks to have appropriate policies on credit underwriting and advances and on monitoring the adequacy of collateral pledged for advances. They also impose safety and soundness considerations on the FHLBanks' pricing and on setting maturities of advances, among other things. Thus, the Bank Act, Finance Board regulations and policies, and the FHLBanks' own policies and procedures operate together in ensuring that the credit risk on FHLBank advances is extremely low. In fact, in the 65-year history of the FHLBank system, no FHLBank has ever experienced a credit loss on an advance.

While advances are the FHLBanks' primary assets, investments also represent a significant asset on their balance sheets.⁶ As with advances, the credit risk of the FHLBanks' investments is tightly controlled by both the Bank Act and Finance Board regulations and policies. The Bank Act authorizes the FHLBanks to invest reserves and surplus funds in securities with relatively low credit risk, such as U.S. Treasury securities, securities issued by Freddie Mac, Fannie Mae or GNMA, and in such securities as fiduciary and trust funds may be invested in under the laws of the state in which the FHLBank is located.⁷

The FHLBanks' statutory investment authority is further restricted by the Finance Board's Financial Management Policy (FMP). The FMP sets forth specific, eligible investments for the FHLBanks and requires the FHLBanks to limit the credit exposure in their investments and to obtain collateral from all but the most creditworthy institutions. Investments in certain high-risk securities and the use of derivatives for speculative purposes are expressly prohibited. Generally, long-term investments are allowed only if the asset is issued or guaranteed by the U.S. government or a U.S. government sponsored agency, or if the asset is rated triple-A and secured. Mortgage backed securities (MBS) that meet these criteria are eligible investments. However, the FMP limits aggregate MBS investment by a FHLBank to three times the Bank's capital, and places restrictions on the types of MBS that a FHLBank may purchase to further reduce risk.

The FMP also requires that unsecured investments be short-term and be placed only with highly rated counterparties. The FMP also instructs the

⁶ As of December 31, 1997, the FHLBanks had total assets of \$348.5 billion, of which \$202.3 billion were advances and \$140 billion were investments.

⁷ 12 U.S.C.A. §§ 1431(h), 1436(a).

FHLBanks to establish limits on credit risk exposure through swaps and other off-balance sheet agreements with counterparties and to obtain collateral when credit exposure exceeds established limits. As with advances, there has never been a known credit loss with any FHLBank investment.

Interest Rate Risk Controls. Like other financial institutions, the FHLBanks are exposed to interest rate risk whenever the cash flows associated with their assets and liabilities are not well matched over time. Unlike other federal financial regulators, the Finance Board has imposed strict limits on the amount of interest rate risk exposure that each FHLBank may assume. These limits include a stress test for sudden changes in interest rates, as well. The FMP requires each FHLBank to maintain its duration of equity – a commonly used measure of interest rate risk – at very conservative levels. The Finance Board monitors each FHLBank's duration of equity on a quarterly basis to assure compliance. By using a variety of risk management techniques – e.g. match funding advances and investments by issuing debt with similar structures, issuing callable debt, and using interest rate swaps and options to hedge their positions – the FHLBanks generally stay well within the conservative regulatory limits set by the Finance Board.

2. Corporate Governance, Risk Management, Auditing and Disclosure Requirements Help Ensure Safety and Soundness.

The senior management and boards of directors of the FHLBanks also play vital roles in ensuring safety and soundness, and the Finance Board uses this corporate governance structure to help fulfill its safety and soundness duty. Specifically, the Finance Board requires that the senior management of each FHLBank (1) establish internal control systems to ensure compliance with Finance Board policies and regulations and (2) report monthly to its board of directors and the Finance Board on regulatory compliance. The Finance Board also requires that the internal auditor of each FHLBank establish internal auditing programs that test for compliance with its safety and soundness policies.

Because the FHLBanks are subject to the Government Corporation Control Act, they are also required to have annual audits conducted by independent outside auditors in accordance with the Comptroller General's auditing standards. These standards, which are in addition to those for SEC registrants, require reviews, attestations, and public reporting on the results

of internal control testing. Moreover, although the FHLBanks are exempt from SEC registration and reporting requirements, the Finance Board recently adopted a policy that requires the System's financial reports be prepared in a manner consistent with, to the greatest extent practicable, SEC disclosure requirements. Such extensive auditing and disclosure requirements provide additional safety and soundness protection.

3. FHLBanks Are Required To Be Well-Capitalized.

Capital requirements, which ensure a buffer against loss, are a critical safety and soundness tool employed by financial regulators. The capital requirements of the FHLBanks are specified in the Bank Act.⁸ These statutory capital requirements, together with the Finance Board's regulation limiting the System's debt to 20 times capital,⁹ assure that the FHLBanks have capital-to-asset ratios which approximate the 5 percent ratio for well-capitalized depository institutions and are about twice the 2.5 percent capital-to-asset requirements for Fannie Mae and Freddie Mac.

On a risk-adjusted basis, the FHLBanks are even better capitalized. To be considered well-capitalized, depository institutions must have total risk based capital of 10 percent, and, as of year-end 1997, insured depository institutions held 12.65 percent risk-based capital on average. By comparison, the FHLBanks held over 22 percent risk-based capital at year-end 1997.

4. Annual Examinations Assure Compliance with Safety and Soundness Standards.

The Bank Act mandates annual examinations of the FHLBanks.¹⁰ During such examinations, critical risk areas, such as financial management, interest rate risk compliance and modeling, FMP compliance, and the integrity of internal controls over various banking operations, are routinely reviewed. Where operational issues suggest weaknesses in management or board oversight, such weaknesses are pursued. Examiners also routinely review board minutes and other materials.

⁸ 12 U.S.C.A. § 1426. Members must purchase capital in their FHLBank equal to the greatest of 1 percent of their residential mortgage assets, 0.3 percent of total assets, or 5 percent of their outstanding balances. *See, also, id.*, § 1430(e).

⁹ 12 C.F.R. § 910.1.

¹⁰ 12 U.S.C.A. § 1440.

Examiners review internal audit materials in the course of planning and executing each examination. Where review or testing in areas covered by internal audit materials suggests weaknesses in the scope or execution of the internal audit function, such weaknesses are pursued. For example, in reviewing interest rate risk modeling and pricing of MBS, examiners select a sample of such securities, check their prices and interest rate sensitivity against management and internal audit reports, and explore any discrepancies. Examiners have found that testing data at the operational level is an effective way to test the reliability of the audit function.

Substantial examination resources are devoted to reviewing the FHLBanks' financial modeling, which supports their monthly reporting to the Finance Board of compliance with the interest rate risk limits and other requirements of the FMP. The Office of Supervision prepares a quarterly report reviewing such compliance. This report provides a bank-by-bank discussion of key risk issues, including compliance with FMP limits on counterparty creditworthiness, credit concentrations, and interest rate risk sensitivity. The report also tracks the market value of FHLBank equity as compared to book value, as well as the sensitivity of that market value to 200 basis point interest rate shocks.

Examination findings requiring mandatory corrective action generally are set forth in examination reports which constitute a "supervisory determination," to which FHLBank management and directors must respond in writing. FHLBanks may dispute examination findings requiring mandatory action in accordance with Finance Board procedures, but must comply with the determination unless it is stayed by the Board of Directors of the Finance Board. The Finance Board is empowered by the Bank Act to issue orders as necessary to effect enforcement¹¹ and to suspend or remove for cause a director, officer, employee or agent of any FHLBank.¹² The Finance Board also has statutory authority to liquidate, reorganize or merge any FHLBank upon finding that the efficient and economical accomplishment of the purposes of the Bank Act would be aided by such action.¹³ There has never been an unimplemented directive from the Finance Board.

¹¹ *Id.*, § 1422b(a)(1).

¹² *Id.*, § 1422b(a)(2).

¹³ *Id.*, § 1446.

- B. *GAO incorrectly assumed that examinations are the Finance Board's sole safety and soundness tool, and limited its work to a narrow review of examination procedures. Therefore, its work cannot support any conclusions regarding the overall effectiveness of the Finance Board's safety and soundness oversight.*

In reviewing the examination function, GAO limited its work to a mechanical comparison of examination work papers against programs set forth in the Finance Board's examination manual (Manual). Congress requested that GAO review the *effectiveness* of the Finance Board's oversight efforts as safety, soundness and mission regulator of the FHLBank System. The narrow scope of GAO's audit and their audit methodology cannot support any conclusions regarding the "effectiveness" of the Finance Board's regulatory oversight. GAO's methodology overlooked critical matters necessary to any assessment of effectiveness:

- ◆ GAO did not assess the strong financial condition, performance, or low risk profile of the FHLBanks.
- ◆ GAO did not assess the critical role performed by conservative risk limits, set forth in the Bank Act, regulations, and financial management policies of the Finance Board and FHLBanks, in ensuring FHLBank safety and soundness.
- ◆ GAO did not assess how such regulatory risk limits, agency oversight, and the examination program function together to ensure safety and soundness.
- ◆ GAO did not consider the extent to which actual examination output over the sample period – the reports and findings delivered to the FHLBanks -- effectively addressed the risks to be controlled at the FHLBanks. For example, GAO did not consider that 67 percent of the examination

findings¹⁴ made during its two-year sample period dealt with internal controls, management and board oversight, and internal audit -- areas GAO contends the Finance Board did not "always fully assess."

◆ GAO did not uncover any evidence of actual difficulty in practice in achieving FHLBank compliance with examination findings, yet criticized the Finance Board's enforcement program as lacking clear policies and procedures.

◆ GAO did not consider that the bulk of the Finance Board's staff, and most of the goals listed in its Strategic Plan, focus on safety and soundness and compliance issues.¹⁵

GAO identified two instances where examination scope was curtailed without explanation, and two instances where examination scope was not expanded despite identified control weaknesses.

The two scope curtailments were in low risk areas -- regular and discount advances and member applications. To maximize examination efficiency, it is standard practice to de-emphasize low priority items in the field in favor of higher risk matters.

¹⁴ GAO reviewed 26 examination reports from 1996 and 1997, containing 205 findings. Findings are generally labeled in reports by the operations area in which they are made. Here is a substantive breakdown of the findings by the critical areas identified by GAO -- internal controls, internal audit, and management and board oversight:

Finding Type	Distribution (%)
Internal Controls (arising in financial management, information technology, departmental operations, affordable housing program, and other operations)	61.5
Internal Audit	3.4
Management and Board Oversight	<u>2.5</u>
Findings in GAO Critical Areas	67.4
Other findings	<u>32.6</u>
	100.0

¹⁵ For example, with respect to the Strategic Plan, Goals/Objectives I (examination), IIA (legislation), IIE (FMP), IILA (Devolution), and IIIB (compliance assistance), each have a strong safety and soundness or compliance component. GAO misread the Strategic Plan, incorrectly concluding from the fact that only one agency objective set forth therein deals with the examination function, that the Strategic Plan does not sufficiently emphasize safety and soundness.

Similarly, neither of the control weakness findings GAO identified involving segregation of duties warranted an expansion of examination scope.

Correction of the weakness, as examiners recommended and the FHLBank implemented, was sufficient to satisfy the examination goal of assuring the integrity of internal controls to avoid material losses or capital impairment. The further search for "undetected transactions or losses" arising from the weakness, as recommended by GAO, would have been unnecessary and inefficient from an examination standpoint, since these procedures had been corrected and there was negligible risk of material loss.

Conclusion. Ensuring the safety and soundness of the FHLBanks is the top priority of the Finance Board, as reflected in and reinforced by statute, Finance Board regulations and policies, the Finance Board's strategic plan, the Finance Board's allocation of staff resources, and the Finance Board's examination process. GAO's reliance on comparing a sample of Finance Board exam reports to its Manual did not consider the many elements of the Finance Board's safety and soundness regime and misinterpreted the elements it did consider.

II. Ensuring that the FHLBanks carry out their housing finance mission.

- A. *In order to ensure that the FHLBanks carry out their housing finance mission, the Finance Board must actively foster the maximizing of public benefit from the activities of the FHLBanks.*

Housing finance¹⁶ is the public purpose for which the FHLBank System was created. This public purpose is accomplished by the FHLBanks providing housing and community investment credit through member financial institutions. Just as the Finance Board has a statutory duty to ensure that the FHLBanks operate in a financially safe and sound manner, the Finance Board has a statutory duty to ensure that the FHLBanks carry out their housing finance mission consistent with their safe and sound operation. Both duties, of necessity, involve the agency to some degree in the FHLBank System's business.

¹⁶ The Finance Board has long and consistently interpreted "housing finance" to include the statutorily mandated activities of "community investment" that were added to the Bank Act by FIRREA, *see* *Id.*, § 1430(j)(10); 12 CFR 935.1.

As with safety and soundness, the primary tools for ensuring mission achievement are interpretations of the Bank Act, promulgation of regulations and policies, and the FHLBanks' own policies and programs. Once again, the Finance Board does not view examinations as its sole mission regulatory tool. The Finance Board looks primarily to the Bank Act and at the actual business and balance sheets of the FHLBanks to assess the mission performance of the FHLBanks. The Finance Board has also identified for the FHLBanks products and activities which would advance the public interest in housing finance.

The Bank Act specifies several specific products which support housing finance, such as the Community Investment Program,¹⁷ the Community Support Program,¹⁸ other Community Investment Cash Advance programs,¹⁹ as well as advances generally. In addition, there is a requirement that the FHLBanks contribute 10 percent of their net income, but not less than \$100 million annually, to an Affordable Housing Program (AHP),²⁰ to provide subsidies to members engaged in lending for long term low and moderate income owner occupied and affordable rental housing.

Currently, only about 1 percent of the FHLBanks' assets are comprised of AHP and CIP lending, and about 40 percent of the System's balance sheet is in assets that do not directly support the delivery of housing and community investment credit by the FHLBanks through their members. Assets that do not directly support the mission of the System, other than to provide arbitrage profits to enhance System earnings, should be transformed into assets that help members provide housing and community investment credit, as advances do. Therefore, the Finance Board has engaged in an affirmative strategy to actively encourage replacing these investment arbitrage assets with mission-related assets.

The Finance Board has promulgated regulatory initiatives, held hearings on changing the balance sheet of the FHLBanks, met with representatives of the FHLBanks and their members, set goals in its strategic plan, required the

¹⁷ 12 U.S.C.A. § 1430 (i).

¹⁸ *Id.*, § 1430 (g).

¹⁹ *Id.*, § 1430 (j)(10).

²⁰ *Id.*, § 1430(j).

FHLBanks to submit annual mission compliance reports as a part of the annual examination process, continued to develop pilot procedures, and approved four FHLBank pilot programs. Further, the Finance Board's primary emphasis on safety and soundness has assured that no initiatives are implemented until they have been assessed for risk, appropriate policies and procedures and risk management controls have been developed and put in place, and sufficient pre- and post-implementation examination and monitoring arrangements have been planned.²¹

The recent pilot programs are innovations in products developed through member institutions and FHLBanks. These pilots were not mandated by the regulator. Rather, the Finance Board encouraged members and the FHLBanks to "knock on the door" with creative programs to meet the System's mission, and they have responded to the call. The four authorized pilot programs also are the best examples of the Finance Board's primary emphasis on safety and soundness while ensuring mission achievement. Initial approval of each pilot was based on its providing credit support for housing or community investment not available on comparable terms in the private marketplace. Once approved, implementation of each FHLBank's pilot activities has required an extensive prior examination to verify that the FHLBank has put the needed policies, procedures and controls in place to assure that its pilot does not compromise that FHLBank's or the System's safe and sound operation. And, these pilots are subject to ongoing examination of their operations.

The Finance Board also has undertaken a number of regulatory initiatives aimed at clarifying mission, at measuring mission and at devolving governance to the Banks as the statute permits. For instance, in 1997, the Finance Board adopted comprehensive revisions to its regulations governing the AHP. In addition to devolving the administration of the AHP to the FHLBanks, the amended regulations were structured to increase the AHP's effectiveness, streamline the application process, clarify standards, reduce regulatory burden and strengthen the Finance Board's ability to enforce both the regulatory and statutory standards of the program.

The Finance Board has proposed regulations whereby the FHLBanks may target the use of letters of credit to mission-related activities, and whereby

²¹ See, i.e., "Pilot Procedures and Pilot Proposal Initial Submission Guidelines," Finance Board Resolution No. 97-70 (Nov. 12, 1997).

the FHLBanks may establish "Community Investment Cash Advance Programs" authorized by the Bank Act.²² Both of these proposed regulations contain standards for assuring that these mission-oriented activities will be conducted safely and soundly by requiring both activities to be fully secured by specified collateral and by requiring that the FHLBank develop appropriate policies and procedures concerning these activities. As always, safety and soundness remain the Finance Board's primary consideration.

The Finance Board has also established a Compliance Assistance Division in its Office of Policy to work with the FHLBanks and provide technical and other assistance in complying with statutory, regulatory and policy requirements. That office works closely with the Office of Supervision and the Office of General Counsel to address and resolve issues related to the AHP and the FMP, among others. In its role of ensuring that the FHLBanks carry out their housing finance mission, the Finance Board also has established a Market Research Division within the Office of Policy to work with the FHLBanks, their members, customers, and potential customers to assist in developing new mission-related assets for the FHLBanks.

- B. In reaching conclusions as to whether the Finance Board is meeting its statutory duty to ensure that the FHLBanks carry out their housing finance mission, GAO looked to whether the Finance Board has policies and procedures in place sufficient for the Finance Board to make that judgment. This passive view of the Finance Board's duty is inconsistent with the plain language of the Bank Act. The Finance Board's statutory duty is to ensure the housing finance mission is carried out consistent with the primary duty to ensure safety and soundness, not simply to form a judgment as to whether the mission of the FHLBanks is being carried out. In meeting this duty, the Finance Board actively works with the FHLBanks and carefully balances its combined mission and safety and soundness responsibilities.*

²² "Federal Home Loan Bank Standby Letters of Credit – Proposed Rule." (63 Fed. Reg. 25726 (May 8, 1998)); "Community Investment Cash Advance Programs – Proposed Rule." (63 Fed. Reg. 25718 (May 8, 1998)).

GAO's draft report demonstrates a total lack of understanding of what effective mission regulation entails. To read the report, one would think measuring what the FHLBanks do and saying "yes" or "no" to new initiatives is sufficient. Such an approach would not "ensure" any level of mission achievement. As GSEs, the FHLBanks have a special congressionally mandated duty to carry out their mission and the Finance Board is statutorily charged with defining what activities qualify and what activities do not. To "promote" the public interest is precisely what the Finance Board must do.

A mission regulator actually must follow at least three different strategies to ensure mission performance: (1) it must measure what is being accomplished; (2) it must authorize or refuse to authorize activities as mission-consistent, subject to safety and soundness considerations; but also (3) it must define public needs which the regulated entities should be meeting and mechanisms and procedures to move them toward doing so. Who else but the public sector regulator is to have the final say on what the public interest is with respect to a GSE? Only Congress.

These are the standards by which the Finance Board seeks to ensure that the FHLBanks carry out their mission. In contrast, GAO established no criteria or standards in its draft report against which to measure or judge the success of the Finance Board as a mission regulator. GAO fails to assess the actual results of the agency's efforts to fulfill its responsibility to ensure that the FHLBanks carry out their housing finance mission, and instead confuses mission regulation with improper intrusion in the Banks' managerial affairs and corporate governance. In fact, as the draft report acknowledges, the Finance Board agrees that, to the extent possible within statutory parameters, it should devolve FHLBank managerial and administrative matters to the boards and management of the FHLBanks, and it has been doing so. The Finance Board has never sought to tell the FHLBanks how to conduct their businesses. Rather, the Finance Board is focused on what credit needs in housing finance and community investment should be addressed and for which segments of the population.

Thus, it is impossible for an effective mission and safety and soundness regulator not to be involved with System business, as GAO suggests would be preferable. It is the proper role of a GSE regulator to set the parameters within which the regulated entities must operate to ensure that the government supplied subsidy is directed to the maximum extent possible to

the achievement of the GSE's public purpose and that this is accomplished in a financially safe and sound manner.

The GAO draft report is critical of what it calls the "coordination" activities of the Finance Board Chairman in his meetings with the FHLBank chairs and vice chairs. The two items of concern identified are legislation and planning for an annual directors' conference. Throughout the draft report, GAO fails to analyze the connection of these subjects to the Finance Board's proper concerns and extrapolates them to suggest "coordination" of the management of the FHLBanks, which is never a part of these activities.

The legislation which the Finance Board Chairman has been promoting is that which GAO advocated in 1993.²³ It is essential to eliminating the Finance Board's statutory FHLBank management role, to establishing risk-based capital, to giving the Finance Board modern regulatory powers, and to ending the structural flaws which require substantial non-mission investments. Getting such legislation passed is essential to the future safe and sound and mission advancing operation of the FHLBanks. Legislation does not pass itself nor get passed over the opposition of the affected FHLBanks. A regulator that did not seek to coordinate success in this process would not be doing its job.

Similarly, the directors' conference was planned to assist the FHLBanks in understanding and planning for the Finance Board's initiative to reduce non-mission promoting investments.²⁴ Once again, facilitating success in this initiative is the Finance Board's job. The same is true of the other, limited items when "coordination" rather than providing information has been the subject of such meetings.

Part of the draft's confusion stems from failing to analyze specifically the inherent conflict between safety and soundness and mission accomplishment. But the Finance Board fully understands this issue. Consistent with its statutory responsibility, safety and soundness is the

²³ U.S. GAO Report, "Federal Home Loan Bank System—Reforms Needed to Promote Its Safety, Soundness, and Effectiveness," Dec. 1993.

²⁴ See, "Notice – Hearing on FHLBank Investment Practices and an Approach for Limiting Certain Non-Housing-Related Investments," 63 Fed. Reg. 16505 (April 3, 1998); "Making the Best News Real: Leading the FHLBank System into the 21st Century," remarks of Chairman Bruce A. Morrison at FHLBank Directors' orientation, Jan. 27, 1998; "Maximizing the Value of the FHLBank System," remarks of Chairman Bruce A. Morrison at FHLBank Directors' Conference, June 2, 1998.

overriding principle in everything the Finance Board does. As discussed in II.A. above, no initiatives are authorized by the Finance Board or implemented by the FHLBanks until the initiatives have been assessed for risk and until appropriate risk management controls have been put in place and pre- and post-examination arrangements have been planned.

The fact that an agency authorizes an activity does not mean that the agency cannot then effectively examine and supervise the activity for safety and soundness. For instance, the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) charter financial institutions, yet have no difficulty regulating, examining and supervising those institutions for safety and soundness. All of the financial institution and GSE regulators approve applications whereby institutions in their regulated communities seek to engage in various activities; that does not hinder those agencies in their examination, supervision or regulation of the authorized activities.

Further, the fact that an agency exhorts its regulated entities to do what they are required to do by law or what would further their public mission does not prevent the agency from effectively examining and supervising the activity. For instance, the OCC and the OTS routinely “advocate” that their regulated entities fulfill their Community Reinvestment Act (CRA) requirements—having written regulations to guide and facilitate that compliance. GAO has not suggested that those agencies should not engage in that conduct or that those agencies cannot then conduct meaningful CRA examinations because of a conflict of interest. The same is true of the Finance Board’s dual role.

Conclusion: The Finance Board’s strategy of fulfilling its statutory mandate to ensure that the FHLBanks carry out their housing finance mission by actively encouraging the development of mission-related activities by the FHLBanks is entirely consistent with its statutory charge, and represents the regulator seeking to encourage maximization of the public benefit through the stimulation and authorization of financially safe and sound, innovative tools and products. This necessarily involves it in System business to an appropriate degree, while not governing the management of the FHLBanks. ←

III. The Finance Board will review and consider several of GAO's suggestions to improve examination procedures.

In the course of its review, GAO compared the Finance Board's examination manual procedures to examination documentation to determine the extent to which the documentation evidenced compliance with the procedures. This method permitted GAO to make some useful procedural recommendations for greater consistency between written procedures and examination practices.

GAO found inconsistencies between Manual procedures and documented examination work. The need to ensure appropriate documentation of the examination process and consistency with examination standards must be balanced against the need to maintain flexibility and effectiveness in the field. The examination process differs from the audit process, in that it focuses on critical risks and controls that might materially affect the soundness of the institution, and correspondingly has more limited coverage. Adhering to fixed examination programs, irrespective of the need to redirect examination resources to particular areas based on the facts uncovered, would impair examination effectiveness.

In light of GAO's recommendations, the Finance Board plans to review the extent to which the balance between procedural regularity and necessary flexibility has been appropriately maintained in the examination process. Several options will be explored, including: (1) enhancing documentation of procedures conducted in the field, including conformity to those suggested in the Manual; (2) increasing examination staff to permit added attention to such documentation; and (3) better tailoring the Manual's examination programs to the operations and risk profiles of the FHLBanks and the actual experience of examiners in the field.